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Client Alert

Bankruptcy, Financial Reorganization & Creditors' Rights,Investment Management

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Lessons From Merit Management: The Settlement Payment Defense Lives … if You Are a "Financial Institution

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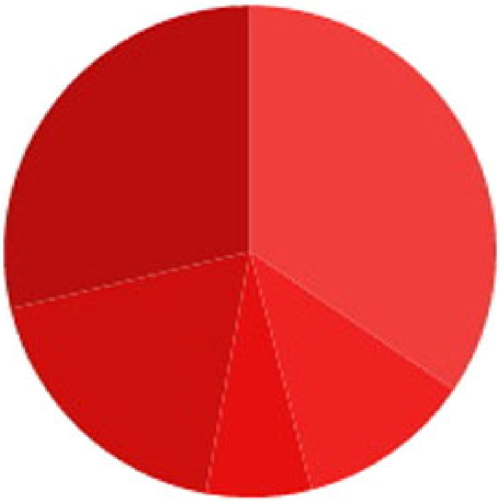
What You Need To Know:

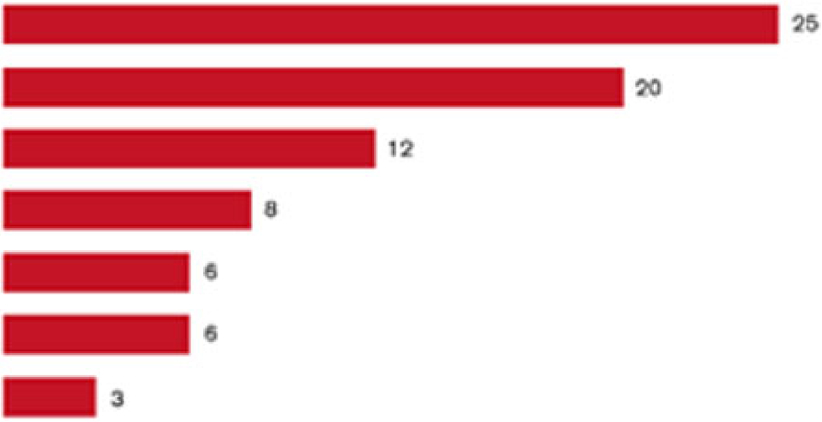
- In Merit Management, the Supreme Court squarely addresses and resolves the circuit court split on whether the "settlement payment" defense can be implemented to insulate subsequent transferees in a constructive fraud case.
- By agreeing with the Seventh Circuit, courts are now instructed to look at the entire transaction as a whole and focus on the ultimate transferee, rather than the existence of an intervening "financial institution."
- The "settlement payment" defense, however, remains a viable defense if the involved party is considered a "financial institution," the definition of which the Supreme Court elected not to address in the Merit decision.

In a much-awaited decision, the Supreme Court finally resolved the longstanding split among the circuit courts regarding the applicability of the "settlement payment defense" under 546(e) of the Bankruptcy Code (*the Settlement Payment Defense*). The *Merit Management*[1] Court's focus on § 546(e)'s scope should ease the minds of those who worried the Supreme Court would limit the Bankruptcy Code's definition of a "financial institution."[2]

1. THE SETTLEMENT PAYMENT DEFENSE

The Settlement Payment Defense shields covered entities from constructive fraudulent conveyance actions by precluding a trustee from recovering a "settlement payment" or "transfer" made "by or to (or for the benefit of)" these entities, including financial institutions. Many defendant-transferees raise the Settlement Payment Defense to protect their received settlement payments.





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2. PRE-*MERIT MANAGEMENT* CIRCUIT SPLIT

Prior to the *Merit Management* decision, circuit courts had two views on the reach of the Settlement Payment Defense. One view (the *Plurality View*), subscribed to by five circuit courts, allowed the existence of a financial institution in the chain of transfers to insulate subsequent transferees from liability. While the defendant, typically the transaction's ultimate transferee, is not a covered entity, the financial institution that makes the final payment to said transferee usually is. Thus, the theory goes that if one of the component parts to the transaction is a covered entity, the whole transaction is protected by the Settlement Payment Defense.

The Seventh Circuit proposed a different view (*the Seventh Circuit View*), which looked at the transaction as a whole and focused on the ultimate transferee. Namely, the Seventh Circuit held that the Settlement Payment Defense did not apply when the only covered entity is the financial institution that served as a mere conduit for the distribution of payment to the transferee.

In *Merit Management*, one side argued in favor of the Plurality View, and the other asserted that the Seventh Circuit View applies.

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3. BRIEF FACTS IN *MERIT MANAGEMENT*

The *Merit Management* case involved a chapter 11 trustee (the Trustee) that identified what it considered to be a constructive fraudulent transfer from the Debtor to a transferee (the Transferee). The Trustee alleged that the Debtor purchased stock from the Transferee at a price that did not provide fair value.[3] Therefore, the Trustee filed suit to recover ("avoid") the allegedly dubious pre-petition payments.

The Transferee filed a motion on the pleadings, whereby it argued that the Settlement Payment Defense barred the Trustee from recovery pursuant to the Plurality View. Specifically, the Transferee argued that the Settlement Payment Defense insulated the relevant transaction from scrutiny, because the final payment to the Transferee was not made by the Debtor, but rather "by" a protected intermediary: a financial institution that served as a conduit for the transfer of payment. The Trustee countered with the Seventh Circuit View: the Settlement Payment Defense cannot be used to insulate transfers that were made through a financial institution but did not involve said financial institution as a direct party.

The Supreme Court agreed with the Trustee, but on broader grounds.

4. THE *MERIT MANAGEMENT* HOLDING

The *Merit Management* Court did not did limit the definition of a "financial institution" in any way. Instead, it simply held that when considering the Settlement Payment Defense, courts are to concentrate on the overarching transaction from initial transferor to end transferee, and not on the component parts.

Focusing its discussion on this general holding, the *Merit Management* Court clarified that using a financial institution as a mere conduit for the distribution of funds does not shield a transaction from avoidance actions. Essentially, courts should "look to the transfer that the trustee seeks to avoid (i.e., A D) to determine whether" the Settlement Payment Defense insulates said transfer, and should not look to the "component parts of the overarching transfer (i.e., A B C D)."[4]

The Supreme Court did not discuss whether the Debtor or the Transferee qualified as a "financial institution." Thus, despite *Merit Management's* holding, defendants can still avail themselves of the Settlement Payment Defense if they claim "financial institution" status as part of their defense.

5. POST-*MERIT MANAGEMENT* IMPLICATIONS

While the decision will deprive some avoidance defendants of the ability to use the Settlement Payment Defense, said defense still applies when the financial institution asserting the Settlement Payment Defense is the conduit-bank's "customer." The *Merit Management* ruling did not limit the Bankruptcy Code's definition of a "financial institution." As previously stated, the Settlement Payment Defense precludes a trustee from avoiding a "settlement payment" or "transfer" made "by or to (or for the benefit of)" "financial institutions."

The Bankruptcy Code's definition of "financial institutions" includes the "customer" of certain banks or commercial entities when a bank or commercial entity acts as an agent or custodian for the customer in connection with a securities contract.[5] Hypothetically speaking, a transferee that is also a customer of a bank or commercial entity serving as an intermediary to a transaction could use the Settlement Payment Defense to insulate itself from an avoidance action, given that the Bankruptcy Code also defines said customer as a protected "financial institution."

At the *Merit Management* oral argument, Justice Stephen Breyer suggested that this might be a valid justification for transferees to continue using the Settlement Payment Defense.[6] However, the Court chose to not discuss the Bankruptcy Code's definition of a "financial institution," as the Transferee conceded the aforementioned point in the lower courts. Thus, it still remains true that a financial institution may avail itself of the Settlement Payment Defense if it is one of the transacting parties, as opposed to an intermediary.

Given this development, the main takeaway for securities market participants is that they must demand a detailed transfer structure that gives them "financial institution" status in order to curtail avoidance liability. Many circuit courts are mindful of the importance of financial market stability and certainty, and the detrimental effects that would result from subjecting all securities transactions to avoidance actions. By insisting on a transfer structure whereby transferees fit within the Bankruptcy Code's definition of a "financial institution," market participants will safeguard their securities transactions from avoidance risk.

6. CONCLUSION

Focusing its attention on *Merit Management's* specific facts, the Supreme Court's ruling appears to leave in place protections for certain shareholders receiving settlement payments under securities contracts. Going forward, market participants that seek certainty and finality in their transactions will be wise to ensure that they qualify for "financial institution" status prior to entering into a securities transaction.

The Supreme Court agreed with the Trustee, but on broader grounds.

[1] *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, No. 16-784, 2018 WL 1054879 (U.S. Feb. 27, 2018).

[2] 11 U.S.C. § 101(22).
[3] The Bankruptcy Code allows a trustee to seek the avoidance of fraudulent transfers. 11 U.S.C. § 548(a).
[4] *Merit Mgmt. Grp.*, 2018 WL 1054879, at *3, 12.
[5] 11 U.S.C. § 101(22).
[6] See Transcript of Oral Argument at 13-20, *Merit Mgmt. Grp., LP v. FTI Consulting, Inc.*, No. 16-784, 2018 WL 1054879 (U.S. Feb. 27, 2018) (available here).

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Chapter 1

What You Need To Know:What You Need To Know: 1. Regulation A is being made available to all reporting companies.

2. The change will likely have the greatest benefit for smaller reporting companies.

3. The availability of Regulation A will make it easier for smaller reporting companies to raise capital as compared to current options. On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act was signed into law. While press coverage of the Act mostly focused on its rollback of regulations applicable to financial institutions and originating in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, significantly, the new Act also requires the U.S. Securities and Exchange Commission (SEC) to amend its rules to permit reporting companies to use Regulation A.Regulation A provides an exemption from the registration provisions of the Securities Act of 1933, as amended (Securities Act), by permitting offerings of up to $20 million in any one-year period (Tier 1 Offerings) and offerings of up to $50 million in any one-year period (Tier 2 Offerings) subject to compliance with certain requirements. Until now, Regulation A has only been available to U.S. and Canadian issuers that were not subject to the reporting requirements of the Securities Exchange Act of 1934, as amended (Exchange Act). However, the new law orders the SEC to remove this eligibility requirement, making Regulation A available to all reporting companies, and mandates that the ongoing reporting obligations associated with Tier 2 Offerings are satisfied by Exchange Act reporting (which a public company already does).**What This May Mean for Smaller Public Companies**There are three significant advantages that this expansion of Regulation A is expected to have for smaller companies that are already public.First, reporting companies that do not trade on national securities exchanges (for example, those that trade in the over-the-counter markets) will be able to avoid state securities law requirements by conducting future offerings in compliance with Tier 2 of Regulation A.Second, Regulation A permits issuers to do significant investor outreach prior to submitting an offering statement to the SEC, including solicitations of written indications of interest. That outreach will enable smaller reporting companies to gauge investor interest in their securities by contacting retail as well as institutional investors before committing to the expense of preparing an offering circular.Third, Regulation A will allow smaller public companies to make offerings to retail investors through a general solicitation without having to comply with the burdensome income verification requirements of Rule 506(c) under Regulation D.**Offerings Off-the-Shelf**Rule 251(d)(3) of Regulation A permits certain offerings to be made on a delayed or continuous basis pursuant to a qualified offering statement. However, as currently written, Rule 251(d)(3) would not permit an issuer to conduct a delayed primary offering off-the-shelf. In the spirit of the legislation, the SEC may decide to expand Rule 251(d)(3) to permit shelf offerings to expand the utility of Regulation A and bring it into closer conformity with Rule 415. However, if the SEC elects to do so, it may impose restrictions on such offerings, including limitations on which issuers can use any shelf offering procedure and limitations on the amount that may be sold, similar to those contained in the baby shelf rule in General Instruction I.B.6. to Form S-3.**Eligibility**Regulation A is not available to certain issuers, such as companies organized outside the U.S. and Canada; shell companies; investment companies; issuers of interests in oil, gas and other mineral rights; issuers of asset-backed securities; issuers that have had their securities denied or suspended from registration by the SEC within the past five years; and issuers that are disqualified by any bad actor events involving the issuer or any of its affiliates. However, this expansion of Regulation A is likely to provide significant relief to qualifying smaller reporting companies.*The full text of S.2155, Economic Growth, Regulatory Relief, and Consumer Protection Act is available here.*